SECURITIES LAW CONSIDERATIONS

THE IMPORTANCE OF SECURITIES LAW COMPLIANCE

A company that is attempting to raise funds by issuing securities must comply with federal and state securities laws. Securities laws regulate all securities, including stock and debt instruments, and dictate the manner in which they can be sold, the amount of securities that can be offered and the persons to whom securities can be offered in a particular offering.

Securities laws are exceedingly complex and technical. To add to the complexity, federal and state securities laws are not completely consistent with each other, and compliance with federal securities laws does not assure compliance with applicable state securities laws. In addition, a particular transaction may require a business to comply with the securities laws of several states, all of which may be different from each other. Compliance with applicable federal and state securities laws is important even with respect to sales of securities to friends or family members, which are not uncommon at the start-up or development stages of a business. A failure to comply with these securities laws can result in significant penalties for both a company and its directors and officers. Some of these penalties include:

- Imprisonment;
- Monetary fines;

- Refund of amounts paid by investors; and
- Prohibition on conducting future sales.

These materials have been prepared to provide entrepreneurs and other business owners with a general understanding of securities laws and some of the procedures that are necessary to comply with them. However, businesses interested in raising capital through the sale of securities should seek competent professional advice, both legal and financial, prior to commencing any capital raising activities.

OVERVIEW OF SECURITIES LAWS REQUIREMENTS

As a general rule, in order to comply with federal securities laws, a person selling any security, must either (i) "register" such sale with the Securities and Exchange Commission ("SEC") or (ii) identify a specific exemption that allows such sale to be conducted without registration. Note that this general rule applies to <u>all sales</u> of securities by all persons and companies. Companies are often surprised to learn that they have sold a security when engaging in seemingly innocuous activities. This surprise is attributed to a lack of understanding of the term "security." Most people think a security is either a share of stock or a bond. However, the definition of security for purposes of federal securities laws is quite broad. Section 2(1) of the Securities Act of 1933 (the "Securities Act") sets forth a definition of the term "security," and the term includes, in addition to stock and bonds, any note, evidence of indebtedness, option or investment contract. This broad definition of security means that virtually any type of instrument in which the investor has a reasonable expectation of profit solely as a result of the investment of money will be subject to the rigor of the federal securities laws, regardless of the structure of the investment. For example, a company that sold investors strips of land in an orange grove and then entered into contracts with the investors to cultivate the land

and harvest the oranges on behalf of the investors was found to have engaged in the sale of a security (and to have violated a multitude of federal and state securities laws).

Another consequence of the broad definition of a security is that a company that borrows money from a founder (or, as is often the case, from a relative of a founder) and issues a promissory note as evidence of indebtedness to the person making the loan has engaged in the sale of a security for purposes of federal securities laws. Fortunately, this type of transaction usually does not result in a violation of federal securities laws because the sale of the note is often exempt from the registration requirements under Section 4(2) of the Securities Act. However, this example illustrates how a company can unwittingly run afoul of securities laws which, as alluded to earlier, can have significant adverse effects on the company and its officers. Other common types of securities that newly formed companies often sell to raise capital include:

- **Common Stock.** Shares of common stock evidence a proprietary interest in the issuing company and typically give the holder voting rights (although common stock can be both voting or non-voting). Common stock is typically the last class of securities on which payments will be made in the event of liquidation of a company and affords the holder little protection other than voting rights. For this reason, venture capital firms will seldom be interested in receiving common stock of a company in which they invest.
- **Preferred Stock.** Like common stock, shares of preferred stock evidence a proprietary interest in the issuing company. However, unlike common stock, shares of preferred stock often afford the holders some protection through class voting rights, preferred dividend rights and liquidation rights. The attributes of preferred stock vary widely and are often heavily negotiated between investors and the issuing companies. The relative bargaining

positions of a company raising money and potential investors will greatly influence how many (or how few) protective provisions will be included for a particular class of preferred stock. Most classes of preferred stock provide for the conversion of the preferred stock into common stock at the option of the investor and the number of shares of common stock that are issuable upon conversion of the preferred stock often increases if the company conducts future offerings at lower prices.

- **Promissory Notes.** A promissory note is a promise to pay someone a fixed amount of money by a certain date or upon the occurrence of certain events (e.g., the sales of a company reaching a certain threshold). Promissory notes usually bear interest at a stated rate, with the interest being payable at some fixed interval or upon repayment of the principal. Promissory notes can be secured or unsecured. A secured note means that the note holder is granted a lien on the assets of the company issuing the note and if the note is not paid on its due date, the note holder is entitled to foreclose the pledged assets. If a company defaults on an unsecured note, the note holder must sue for damages and will only be paid if the company has sufficient unencumbered assets to pay the amount of the note. A promissory note can be either payable at the request of the holder (a demand note) or payable in one or more installments on an agreed upon date or dates (a term note). A promissory note will often provide for an early repayment date in the event that the issuing company fails to meet certain liquidity tests or if the company takes certain prohibited actions that are specified in a note purchase agreement.

- **Convertible Notes.** A convertible note is a promissory note that, by definition, is convertible into equity securities of the issuing company. Most convertible notes are structured so that they can be converted at any time at the option of the investor. Convertible notes are often issued between rounds of equity financing. In this case, the convertible notes are generally converted automatically upon the close of the subsequent equity financing into the type of stock issued in the equity financing. In addition, convertible notes are usually automatically converted into common stock if a company conducts an initial public offering of its stock.

- **Options/Warrants.** An option or a warrant entitles the holder to purchase securities from a company in the future for a certain price. Early-stage investors often receive warrants from the company in which they invest, with the number of shares covered by the warrant equal to a percentage of the number of shares purchased (often between 50% and 100%) with a strike price often equal to the price at which the investor is sold stock of the company. For example, a venture capitalist who purchases 10,000 shares of preferred stock at $1.00 per share might receive a warrant to purchase 5,000 shares of common stock of the company for $1.00 per share at any time within the five year period following investment. Early stage companies who are trying to preserve cash often use warrants to partially compensate consultants or other third parties who are providing critical services to the company.

- **Units.** A unit is not a security itself but is often used to describe the offering of two or more types of securities that are sold together. For example, a company may offer to sell units that consist of 100 shares of preferred stock and a warrant to acquire 50 shares common stock.

- **Limited Liability Company Interests.** The owners of a limited liability company are referred to as members and the ownership rights are evidenced by membership interests. In Minnesota, membership interests are very similar to common stock. Members generally have voting rights based on the number of membership interests they hold. In addition, members typically have participation rights upon dissolution of the company.

The registration process under the Securities Act is often a time consuming and expensive process. Section Seven, entitled "Initial Public Offerings," discusses in more detail the process involved in conducting a public offering through the registration process. Many companies, including those at an early stage of their development, are not able to comply with the registration requirements or are otherwise not suitable for registration of a sale of securities. As a result, finding exemptions from registration is an extremely important part of capital raising activities. An exemption may be granted where sales of securities are deemed not to need the protection of registration, either because the purchaser of the security is deemed not to need the protection of the securities laws or because the capital raising activity is being conducted in such a manner that registration is not necessary to protect the interests of the public.

The particular exemption that can be used in a given situation is dependent upon a number of factors. These factors include:

- The amount of money that is to be raised;
- The number of investors being targeted;
- The types of investors being targeted; and
- The amount of information about the business that can be furnished to investors.

After these factors have been evaluated, the number of exemptions available, if any, may be limited. The ability to conduct a securities offering may further be limited by the fact that an exemption that is available under federal securities laws may not be available in a particular state in which a business intends to sell securities. The next section of this chapter looks at the most commonly used federal exemptions and evaluates some of the major criteria that must be satisfied to use each of them. The Securities Act contains detailed and complex provisions for these exemptions. A full explanation of the operation of these rules is beyond the scope of this publication. However, the overview of each exemption that is provided should give business owners a general understanding of what exemptions from registration are available for a particular offering.

PRIVATE OFFERINGS – FEDERAL EXEMPTIONS

The most common exemptions used to raise capital by entrepreneurs and businesses in their early stages of development are the "private placement" exemptions. Private placement exemptions are often utilized when a relatively small amount of money is being raised from a limited number of investors, though significant amounts of money can be raised pursuant to private placements as well. The private placement exemptions consist of Regulation D and Section 4(2) of the Securities Act, which are described below.

Regulation D

The substance of Regulation D is contained in three separate rules of the Securities Act, Rules 504, 505 and 506. Each of these rules allows a company to raise different amounts of money, and each contains different requirements that must be complied with when conducting an offering under such rule. A comparison of these rules is set forth in the table below.

	Rule 504	**Rule 505**	**Rule 506**
Offering Amount Limitation:	$1,000,000 (during any 12 month period)	$5,000,000 (during any 12 month period)	Unlimited
Number of Investors:	Unlimited	Unlimited accredited investors; up to 35 non-accredited investors	Unlimited accredited investors; up to 35 non-accredited investors
Limitations on Types of Investors:	None	None	Investors who are not accredited must be "sophisticated"
Limitations on Issuers:	Must not be a reporting company, investment company or otherwise disqualified	Must not be an investment company or otherwise disqualified	Must not be an investment company or otherwise disqualified
Information Requirements:	None	Non-accredited investors must be furnished specified information	Non-accredited investors must be furnished specified information
Filing Requirements:	Form D must be filed with the SEC within 15 days after the first sale	Form D must be filed with the SEC within 15 days after the first sale	Form D must be filed with the SEC within 15 days after the first sale
Limitations on Resale	Issuer must exercise reasonable care to assure purchasers are not underwriters except in limited circumstances	Issuer must exercise reasonable care to assure purchasers are not underwriters	Issuer must exercise reasonable care to assure purchasers are not underwriters
Solicitation Restrictions:	General solicitation or advertising permitted only in limited circumstances	No general solicitation or advertising permitted	No general solicitation or advertising permitted

A key definition embodied in Regulation D is the term "accredited investor." An accredited investor is generally a high net worth individual (i.e., presently, an individual with an individual or joint net worth of at least $1,000,000, or an annual individual income of at least $200,000 in each of the last two years, or a joint individual income of at least $300,000 in each of the last two years, or a company with at least $5,000,000 in assets). Directors and executive officers of a company are also "accredited investors" for purposes of acquiring securities from the company. Section Five, entitled "Private Equity Offerings," contains a more detailed discussion of accredited investors.

As indicated in the table above, the concept of an "accredited investor" is important for two reasons. First, both Rule 505 and Rule 506 allow sales to be made to an unlimited number of accredited investors. This is particularly noteworthy for offerings made under Rule 506, which has no limitation on the offering amount, because by targeting a large number of accredited investors, a substantial amount of money can be raised. Secondly, if securities are sold to a non-accredited investor under either Rule 505 or Rule 506, the investor must be furnished with specific information about the business. The amount of information that must be furnished is dependent upon the size of the offering. However, regardless of the size of the offering, some audited financial information will need to be provided to the non-accredited investor. The cost of preparing audited financial statements can be prohibitively expensive for businesses. Therefore, most businesses conducting an offering under Rule 505 or Rule 506 will sell only to accredited investors.

It is important to note that Regulation D, like all exemptions from registration, is only an exemption from registration and does not provide an exemption from other federal and state laws. Transactions under Regulation D remain subject to the anti-fraud, civil liability and other provisions of the federal securities laws. Accordingly, regardless of the requirements of any particular exemption, businesses should always consider the appropriateness of full and complete disclosure of all material information regardless of the requirements of Regulation D. If there is some materially adverse information about a business that has not been made public, such information should be disclosed to investors prior to a sale of securities. If such information is withheld, a purchaser may be able to rescind the transaction at a later date.

One practical step to consider before engaging in a Regulation D offering is the SEC's electronic filing requirements. The Form D must be filed with the SEC through the SEC's Electronic Data Gathering, Analysis, and Retrieval System (EDGAR). To file via EDGAR, an issuer must first be set-up as an electronic filer. This process can take several days. Issuers are wise to take care of this set-up early in the process to avoid scrambling towards the end of the 15 day filing window for the Form D.

Finally, as is the case with all exemptions under federal securities laws, complying with Regulation D will not eliminate the need for a company to comply with applicable state securities laws. This caveat is extremely important with respect to Rule 504. Although many states do not require registration for an offering conducted under Rule 505 or Rule 506, very few have exemptions for offerings conducted under Rule 504. This has the practical effect of limiting the ability of a company to conduct an offering under Rule 504, whereby a large number of investors each contribute relatively small amounts of money, because such an approach would likely require registration in one or more states.

Section 4(2)

Under Section 4(2) of the Securities Act, a transaction by an issuer "not involving a public offering" is exempt from registration. Unfortunately, Section 4(2) does not provide any guidelines as to what does and does not constitute a "public offering." While a company can assure itself of compliance with federal securities laws by following the specific rules set forth in Regulation D, a company that avails itself of an exemption under Section 4(2) can not look to a set of requirements that must be followed to assure compliance with federal securities laws.

A company seeking to determine whether an offering will be exempt from registration under Section 4(2) will need to evaluate a number of factors which, although routinely addressed by courts, seldom lead to a definitive answer as to whether an offering is a "public offering" under Section 4(2). Different courts emphasize different factors critical to the Section 4(2) exemption, no single one of which will necessarily control. These factors are simply used as guidelines. The five factors given the most weight in this determination are:

(i) offeree qualification (i.e., whether the investors are sophisticated);

(ii) manner of offering (i.e., whether the company engaged in advertising or other promotional activities);

(iii) availability and accuracy of information given to offerees and purchasers (i.e., whether the people to whom the company proposes to sell securities have access to basic financial information about the company);

(iv) number of offerees and number of purchasers (i.e., whether the company solicited investment from a large group of people); and

(v) absence of intent to redistribute (i.e., whether the people to whom the company proposes to sell securities have an intention to hold the securities for investment purposes (generally a minimum holding period of 24 months)).

Generally, the fewer the number of offerees and the more current the information available, the greater the likelihood that an offering will not be considered a "public offering." Due to the uncertainty about whether any particular offering will constitute a public offering, Section 4(2) is usually not an exemption that companies rely upon when conducting a securities offering.

OTHER OFFERINGS – FEDERAL EXEMPTIONS

In addition to the private placement exemptions, there are several other exemptions available to companies that wish to raise capital without going through the registration process. Some of these exemptions are summarized below.

Section 4(6)—Accredited Investor Offerings up to $5 Million

Section 4(6) of the Securities Act exempts transactions involving offers and sales of securities by a company under the following circumstances: (a) the offers and sales are made solely to one or more accredited investors; (b) the aggregate offering price does not exceed $5 million; (c) there is no advertising or public solicitation; and (d) the company files a Form D with the SEC.

Regulation A—Unregistered Public Offerings up to $5 Million

Regulation A provides an exemption from registration under the Securities Act for certain offerings not exceeding $5 million.

Regulation A is available to corporations, unincorporated associations and trusts and individuals. Regulation A is not, however, available to investment companies or a development stage company that either has no specific business plan or purpose, or has indicated that its business plan is to merge with an unidentified company. Regulation A is also unavailable to companies filing reports under the Securities Exchange Act of 1934, as amended (the "Exchange Act").

Although Regulation A is technically an exemption from registration, the consequences of relying upon it are in fact similar to those encountered with a registered offering. The similarity arises from Regulation A's requirement that an offering circular be prepared and filed with the SEC and furnished to investors. Regulation A offering circulars contain much of the same information as is required in a registration statement, and requires a significant amount of time to prepare. For this reason, Regulation A is not often used by most start-up companies looking to do an early stage financing round. Companies typically use Regulation A when (i) looking to raise funds from a large group of non-accredited investors or (ii) selling securities to a large number of their employees.

Section 3(a)(11)—Intrastate Offering Exemption

Section 3(a)(1l) of the Securities Act exempts from registration any offering conducted entirely within the state where the company raising funds is incorporated and doing business. Rule 147 provides objective and rather stringent requirements for determining the availability of the Section 3(a)(11) exemption. These requirements state that for the Section 3(a)(11) exemption to be available:

- 80 percent of the company's consolidated gross revenues must be derived from the state in which the offering is conducted;
- 80 percent of the company's consolidated assets must be located within the state in which the offering is conducted;
- 80 percent of the offering's net proceeds must be intended to be used, and actually used, in connection with the operation of a business or real property, the purchase of real property located in, or the rendering of services, within the state in which the offering is conducted;
- the principal office of the company must be located in the state in which the offering is conducted; and
- during the offering period and for a period of nine months from the date of the last sale by the company, all resales of the securities purchased during the offering must be made only to persons resident in the state.

Because of the difficulty of complying with all of the requirements of Rule 147, and the fact that state registration requirements must also be complied with, companies do not typically rely on the intrastate offering exemption.

Regulation S—Offshore Offerings

In general, the registration requirements of the Securities Act apply only to offers and sales made in the United States. Under the SEC private placement rules applicable to offers and sales made in the United States, exemption from registering securities is dependent on not advertising or using general solicitation. Regulation S creates certain "safe harbors" for offshore offerings and permits advertising and general solicitation to attract offshore investors. Regulation S provides exemptions for both the initial sale and for the resale of the securities after they are held for a period, generally one year. However the offer and sale of the securities must be a legitimate offshore transaction; no sales to U.S. citizens or residents are permitted, even if that person is purchasing securities while out of the U.S. However parties must ensure such an offering is permissible under the foreign country's securities laws as well. A meaningful discussion of the sale and resale safe harbors requires a discussion of detailed and complex rules and is beyond the scope of this publication and parties interested in qualifying for the Regulation S exemption should contact appropriate legal counsel to ensure compliance.

Companies considering using the exemption available under Regulation S should carefully evaluate whether such an offering is appropriate to their needs. Significant precautions must be taken to ensure adherence to the limitations and restrictions of the applicable rules. As a result, securities offered pursuant to Regulation S are commonly sold at prices significantly discounted from the public or actual market price of a company's security. Also, the SEC is becoming increasingly skeptical of the validity of any safe harbor where a Regulation S transaction appears to be structured as a way to avoid registration or the resale limitations on securities sold in a previous transaction. Thus, any offering pursuant to Regulation S must be timed so that there are no integration issues or other questions related to previous offerings.

BLUE SKY LAWS

A company selling securities to residents of the United States must comply with federal and state securities laws. State securities laws are collectively and individually referred to as "Blue Sky Laws." These Blue Sky Laws vary among the states, sometimes to a significant degree. In general, however, an offer or sale of a security in any state requires registration of the security in that state or an exemption from such requirements.

In Minnesota, the Blue Sky Laws are found in the Minnesota Uniform Securities Act ("MUSA") and the rules and regulations issued pursuant to MUSA. Any offer or sale of a security made to residents of Minnesota must be registered with the Minnesota Department of Commerce unless the security is a "federal covered security" or an exemption to registration is available. This section highlights the most frequently used exemptions from the securities laws of the state of Minnesota.

Institutional Investors, Accredited Investors, and Federal Covered Investment Advisers

Minnesota provides an exemption for any offer or sale to an institutional investor, an accredited investor, a federal covered investment adviser, or any other person exempted by a rule adopted under MUSA. At the time of publication, Minnesota has not adopted any rules exempting additional persons.

Limited Offerings

Sales by a company to no more than 35 persons present in Minnesota (other than those designated as institutional investors, accredited investors or federal covered investment advisers) during any 12 consecutive months are exempt if the following conditions are met:

- No general solicitation or general advertising is made in connection with the offer or sale of securities;

- The company reasonably believes all the buyers in Minnesota (other than those designated as institutional investors, accredited investors or federal covered investment advisers) are purchasing for investment;

- No commission or other remuneration is paid or given directly or indirectly for soliciting any prospective buyer in Minnesota, except for payments to a broker-dealer or agent registered in Minnesota; and

- Ten days prior to any sale under this exemption, the company has filed with Minnesota a statement of the issuer on the form prescribed (unless the issuer makes sales to ten or fewer purchasers in Minnesota in any consecutive 12 month period, in which case no notice must be filed.

Rule 506 Offerings

Securities issued in reliance on Rule 506 of Regulation D are considered federal covered securities and the offer and sale of such securities are not required to be registered in Minnesota. In order to rely upon this exception from the registration requirements, an issuer must make a notice filing with Minnesota containing the following:

- A copy of the Form D;

- A statement of the aggregate amount of securities already sold or offered to persons in Minnesota;
- A consent to service of process signed not later than 15 days after the first sale of securities to persons in Minnesota; and
- A filing fee, which is currently $100 plus one-tenth of one percent of the maximum aggregate offering price at which the securities are to be offered in Minnesota with total fees not to exceed $300.

Sales to Existing Security Holders

Any transaction pursuant to an offer to existing security holders of the company, including persons who are holders of convertible securities, options, or warrants, is exempt from registration under the following circumstances:

- No commission or other remuneration (other than a stand-by commission) is paid or given directly or indirectly for soliciting any security holder in Minnesota; and
- The commissioner of commerce has been furnished, no less than ten days prior to the transaction, with a written description of the transaction.

Other States

The Blue Sky Laws of many states have similar exemptions to those outlined above, but may structure the exemptions in different ways. For example, all states provide exemptions for offerings conducted under Rule 506, but some states require the filing of a Form D in that state prior to any sales taking place, some require that the form be filed within 15 days after the first sale, and others require no filing whatsoever. A company selling securities in any particular state should carefully review the securities laws of that state prior to engaging in any capital raising activities.

ELECTRONIC DELIVERY OF INFORMATION TO INVESTORS

Regardless of whether a securities offering is registered, a company selling securities is often required to furnish potential investors with information. Despite the increasing popularity of using the Internet and other forms of electronic media to quickly and efficiently communicate information to large groups of people, any company considering using such media to deliver information in connection with an offering and sale of securities should proceed with extreme caution. Section Nine, entitled "Private, Public and Offshore Offerings on the Internet," discusses Internet offerings in greater detail.

Information Delivery for Offerings Exempt from Registration

Companies relying on federal or state law private offering exemptions from registration for the offer or sale of their securities should use particular caution in determining whether to use the Internet for the delivery of information. Such delivery would very likely be considered a general solicitation or general advertising in violation of the manner of offering limitations of Regulation D and in violation of the private placement exemption provided by Section 4(2) of the Securities Act.

Information Delivery for Offerings Registered Under the Securities Act

When the Internet is used to disseminate information in a public offering, the considerations raised regarding its use center around the adequacy of the delivery of information. The concern, specifically, is whether the proposed electronic delivery complies with the notice, prospectus delivery and confirmation of sale requirements of the Securities Act.

In October 1995, the SEC issued an interpretive release which made clear that the use of electronic distribution would generally be deemed an acceptable alternative to paper delivery, even encouraging further technical research, development and application of such media. The release focused on procedures to ensure that prospectuses delivered over the Internet provide potential investors with adequate notice of available information and access to disclosure. In general, the SEC considers electronic delivery to be adequate delivery or transmission for the purposes of federal securities laws when the electronic delivery results in the "delivery to the intended recipient of substantially equivalent information as the recipients would have had if the information were delivered to them in paper form." The interpretive release also laid out certain guidelines to ensure adequate notice and delivery, which generally include the following considerations:

- Steps must be taken by companies to ensure that an electronic delivery results in actual delivery of the information. For example, companies can obtain: (i) evidence that the investor actually received the information (e.g., written confirmation of accessing, downloading or printing the document); or (ii) an informed consent from an investor to receive information through a particular medium, coupled with assuring appropriate notice and access. If a potential investor does not have access to the Internet or refuses to consent to receive electronic disclosure, the company may not offer or sell the security electronically to that investor and will be required instead to make a paper copy to deliver.

- Even if all the investors participating in an offering consent to the use of a certain electronic medium, a company offering and selling its securities in its initial public offering must still make paper copies of its prospectus available for a period of time after the offering to post-offering purchasers to meet the secondary market prospectus delivery requirements of the Securities Act.

- The posting of a prospectus will not, by itself, meet the requirements to provide notice of the availability of a final prospectus, even if consents are received from all investors. Thus, if an investor has not provided an e-mail address to confirm delivery of the notice (e.g., via a return receipt message), a paper notice may be required to be delivered by mail or other means.

- The potential investors must have the opportunity to retain the information delivered or have ongoing access equivalent to personal access to paper copies. Thus, document retrieval procedures should not be overly burdensome or complex.

In April 2000, the SEC issued further guidance on using a website to comply with SEC primary and secondary market disclosure requirements. The SEC determined that information may be disclosed in electronic form if the distribution causes recipients to receive substantially equivalent information to that which would be delivered in paper form. In particular, the SEC indicated that a company's electronic disclosure can be made substantially equivalent to paper form if the company takes certain steps with regard to notice, access and delivery. Finally, the SEC emphasized that electronic disclosure still has the risks of incurring liability, including that which may result from misstatements in required filings and disclosures and out-dated or inaccurate information found on the company's website or a third-party's website that is hyperlinked from the company's website.

Discretion is required in determining whether the Internet should be used in public offerings because meeting the procedural guidelines of the SEC's interpretive releases will not assure compliance with any state or foreign securities laws. For example, an electronic offer made over the Internet may be subject to a state's securities regulations where the offer is accessible within that state, regardless of whether actual delivery of the offer occurred in that state. Thus, a company could be subject to the securities laws of numerous states, even though offers are actually made only in a few. Such broad applicability of state law could be prohibitive to certain small or development stage companies because numerous state laws may be applicable and the state law exemptions typically relied upon in public offerings may not be available to such companies if they are not listed on a national securities exchange.

Securities Act Reform

In July 2005, the SEC made major reforms to the communication restrictions and registration procedures relating to registered offerings under the Securities Act (the "Securities Act Reform"). Prior to the Securities Act Reform, all offers made before filing a registration statement were prohibited, all written offers other than by a statutory prospectus after filing were prohibited and all other writings after a registration statement's effectiveness were prohibited unless accompanied by a final prospectus. The Securities Act Reform relaxed pre-filing period restrictions on business communications and offers for certain issuers. The Securities Act Reform provides that communications by an issuer more than 30 days prior to filing a registration statement will not be a violation of the rules covering communications regarding a registered offering if such communications do not reference a securities offering and the issuer takes reasonable steps to prevent further distribution of that information during the 30 days immediately prior to filing the registration statement.

Moreover, with certain restrictions, the Securities Act Reform permits the use of a "free writing prospectus" (a written communication constituting an offer to sell or a solicitation of an offer to buy securities that are or will be the subject of a registration statement and that is not a statutory prospectus) if the issuer files the free writing prospectus with the SEC. Furthermore, free writing prospectuses are not deemed part of the registration statement under the Securities Offering Reforms, but will still be subject to liability under different federal securities laws.